20 March 2015

Mr Wayne Johnson
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By Email: To: wjohnson@artc.com.au

Dear Wayne,

ARTC Discussion Paper – True Up Test Positive Performance Incentive Mechanisms

I refer to ARTC's invitation to provide submissions regarding the Discussion Paper, True Up Test Positive Performance Incentive Mechanisms dated February 2015 (**Paper**). Vale appreciates the opportunity to provide this submission as part of the consultation process on this issue.

Executive Summary

During the development of the ARTC Hunter Valley Access Undertaking (**HVAU**) an obligation was inserted for ARTC to propose a performance incentive scheme related to the operation of the True Up Test. The aim of the performance incentive scheme was to provide a positive incentive for ARTC's performance to counter any minimum risk approach from ARTC and provide a positive incentive to provide Ad Hoc paths. ARTC has released a Paper for consultation that includes a proposed positive incentive that allows ARTC to retain Ad Hoc Charges outside the revenue Ceiling. ARTC believe the proposed incentive will reinforce ARTC's requirement to make contracted capacity available and unlock access to additional Ad Hoc train paths. The Paper includes several questions designed to help guide stakeholders responses to the proposed incentive.

While Vale is generally supportive of the concept of rewarding an entity for increasing efficiency it believes that setting up a Positive Performance Incentive Scheme (PPIS) under the current revenue cap form of regulation can be challenging. The revenue cap provides ARTC with a low level of revenue risk so the undertaking includes a series of negative incentives driven by a need to ensure ARTC operate the monopoly infrastructure in an efficient and prudent manner to meet their contractual obligations. Vale does not believe it is in a position to support the proposed incentive as ARTC is already compensated for contractual performance under the revenue cap and as it is not clear, the incentive relates to ARTC's outperformance of this contractual position. Vale does not believe the proposed incentive provides greater efficiency on pricing between the different pricing zones or the revenue excluded from the revenue ceiling, or utilisation of the infrastructure as the incentive would not encourage ARTC to promote active trading of capacity by Access Holders. Vale would encourage ARTC to undertake further engagement with stakeholders on the development of an incentive mechanism to identify areas of mutual benefits between itself and Access Holders.

ARTC Proposal

ARTC's HVAU contains an obligation in section 13.5 for ARTC to propose a performance incentive scheme, related to the operation of the True Up Test, to generate positive financial outcomes for ARTC. Clause 13.5 stated objective is for the performance incentive scheme to encourage ARTC, through financial reward, to improve its performance in relation to making Capacity available for use either on a contracted or ad hoc basis, and balancing the negative consequences of failing the system wide True Up Test. This obligation was included in the HVAU by the Australian Competition and Consumer Commission (ACCC) in response to concerns that:

- The True Up Test currently contains only negative incentives for ARTC to perform and this may cause ARTC to adopt a "minimum risk" position, particularly in the context of contracting additional capacity; and
- There was a perceived need for a positive incentive for ARTC to provide Ad Hoc paths.

Under section 13.5 of the HVAU, ARTC is required to publish options for a proposed performance incentive scheme and invite submissions from stakeholders. ARTC is required to, in good faith, consider the submissions provided by stakeholders and prepare a report, and any proposed variations to the HVAU, to the ACCC, addressing options for a proposed performance incentive scheme. On the 6 February 2015, ARTC provided a Paper outlining the issues and context for consideration of a performance incentive scheme, and outlined a proposed performance incentive scheme in section 5 for stakeholder consideration.

ARTC's proposal is to allow it to retain Ad Hoc Charges received from each Pricing Zone at the end of the year after meeting certain criteria. Under Clause 5.4(b) of the Access Holder Agreement (**AHA**), any Ad Hoc Charges received during the year from an Access Holder are rebated up to the point they contribute to the fulfilment of the Access Holder's Annual Contracted Path Usage. This mechanism is already contained within the current AHA to prevent double charging and reduce the amount of any potential redistribution in the Unders and Overs process. ARTC's proposal seeks to add drafting to clause 5.4 that would allow them to establish a pool of funds comprising Ad Hoc Charges received in each Pricing Zone, for each quarter, from each Access Holder, and load point combination after achieving certain criteria. The drafting would allow an end of year adjustment for each pool for any Ad Hoc Charges rebated to the Access Holder under clause 5.4(b). The adjusted pool amount would be available for ARTC to retain above the Ceiling Limit if ARTC passes all the True Up Test requirements for each quarter. ARTC state the outcome of the proposed approach is that it reinforces, via a positive performance incentive, ARTC's requirement to make available sufficient path usages to meet the aggregate Base Path Usages and other obligations for the month.

Section 6 of ARTC's Paper outlines an alternative approach that would permit ARTC to retain an amount equivalent to the non-TOP Charge and 50%-75% of the TOP component. Further, the recovery of Ad Hoc Charges, in relation to an Access Holder, would only apply where that Access Holder had received all Base Path Usage and Tolerance in a given month and, in a given year, has received all Base Path Usage.

Section 7 of ARTC's Paper seeks views in relation to the proposed approach set out in section 5 and provides questions to assist stakeholder's responses.

Questions for Stakeholders

1. **Do you believe a positive performance incentive scheme with financial benefits to ARTC that balance's out any negative incentives currently contained within the TUT and Annual Reconciliation can also add value to you as an Access Holder?**

Vale supports the Paper's view that a PPIS needs to be simple and clear to all stakeholders. The key to achieving this is to ensure the goals clearly state the outcome required, are measurable, are achievable, are relevant to the goals, and there is a clear timeframe for achievement. Vale believes that these key characteristics be considered in the development of any incentive mechanism to ensure it is efficient and transparent to all stakeholders. The transparency of the information and calculation used in the incentive mechanism will be important to allow stakeholders to make informed decisions on their participation, and on the future direction, of the Hunter Valley Coal Chain. Vale believes the starting point for any incentive mechanism is to establish the baseline used to determine the performance of ARTC. Setting and establishing a clear and transparent baseline will assist all stakeholders to make informed choices about the impact of their future decisions. Any incentive mechanism should also include a clear review and approval mechanism with an audit process to assess the accuracy of reporting to the baseline and targets. This review process should also consider the approval mechanism required to approve any changes to the agreed target levels.

Vale is supportive of a positive incentive scheme, and is very encouraged that ARTC wishes to pursue this outcome, however, it does believe further clarity is needed on ARTC's statement that an incentive should balance out any negative incentives contained within the TUT and Annual Reconciliation. The Hunter Valley rail network is a natural monopoly and therefore requires a level of economic regulation to replicate a competitive environment. In attempting to replicate this competitive environment, the HVAU includes incentives to balance the risk between the owner of the monopoly infrastructure and Access Holders. Both positive and negative incentives can add value to an Access Holder by incentivising the appropriate party to manage the risks related to a particular matter. Vale can also see value in the establishment of some incentives that have symmetrical outcomes if there is a symmetrical risk of success. However, Vale believes that due to the monopolistic nature of the Hunter Valley rail network, and ARTC's low level of risk, it is unlikely to be appropriate to have some or all incentives balance out all the negative incentives with a positive performance incentive scheme that includes a financial benefit. ARTC is subject to a revenue cap form of regulation that provides their business with a high degree of revenue certainty so any positive performance incentive that provides further revenue benefits must consider ARTC's low revenue risk position.

Vale believes that ARTC receives compensation for the achievement of contractual capacity and it would be inefficient to provide an incentive, via financial reward, for any performance that is less than contractual capacity and does not flow across the whole supply chain. ARTC is one component of the coal supply chain and efficiency gains achieved by ARTC are of limited value to customers unless it achieves a benefit across the whole supply chain. There is no advantage to an ARTC Access Holder if the efficiency improvement provided through the rail network does not allow the utilisation of this additional capacity through the coal terminal, and ultimately results in additional coal sales opportunities. Vale believes it is important that any positive incentive scheme provide sufficient scope and the appropriate mechanism to ensure that any additional capacity is capable of being utilised within other parts of the coal chain.

Vale believes the primary goal of any logistics supply chain is the achievement of contractual capacity of the system. Achieving the contractual capacity should provide the most efficient cost and utilisation of the infrastructure that will benefit all stakeholders. Vale notes that during the operation of the existing HVAU, the Hunter Valley coal chain system capacity has generally been constrained by the level of rail network infrastructure that has hampered a producer's ability to achieve their contractual position. During this period, ARTC has continued to receive its return on the infrastructure via the revenue cap. Vale believes that financial incentives be linked to coal chain throughput, as ARTC developing additional throughput on its own will not allow the full utilisation of this additional throughput across the coal chain to generate value to Access Holders.

The ability for Access Holders to generate value from the operation of an incentive scheme will be dependent on the transparency of the incentive to all stakeholders. Stakeholders must have a clear understanding of the incentive and have access to all relevant information to allow them to make efficient decisions. Any lack of transparency or information is likely to have a significant impact on a stakeholder's ability to generate value from an incentive.

Vale believes that one of the key steps to raising the level of transparency of an incentive is the establishment of the baseline used to measure the achievement and set the boundaries and triggers that influence the incentive outcome. ARTC state that their proposed incentive scheme would reinforce ARTC's incentive to make contracted capacity available. Current system capacity is not above ARTC's contracted capacity, so Vale is unclear what is the baseline that would exist under the current environment where the HVCCC has determined that the system capacity is not sufficient to meet all ARTC's contractual requirements. Alternatively, once the system capacity does exceed ARTC"s contracted capacity, what mechanisms are in place to encourage ARTC to contract this additional capacity to reduce the incentive for ARTC to maintain this spare capacity for Ad Hoc train paths.

Further, the return on capital provided to ARTC is socialised across Access Holders to achieve ARTC's revenue cap. Effectively all users are paying for the infrastructure whether used for contracted train paths or any additional Ad Hoc paths that are provided. The access charge payable includes an allowance for the return on ARTC's investment in the infrastructure. Vale believes that if revenue is excluded from the revenue Ceiling, then the return on capital component of the Ad Hoc Charge should be removed, as this component is provided for under the calculation of the Ceiling.

2. **Do you support the concept of excluding revenues associated with the positive performance incentive scheme from the Ceiling such that it would allow ARTC to retain revenue above the current Ceiling in certain circumstances? If not, what alternative could be provided to provide a positive financial incentive to ARTC?**

Vale supports the concept of excluding revenues associated with a positive performance incentive scheme from the Ceiling to allow ARTC to retain revenue above the current Ceiling. However, the incentive mechanism needs to be robust to ensure that any excluded revenue does not relate to the provision of ARTC's contractual position. The current Ceiling provides ARTC with a high level of certainty that it will receive the require revenue to achieve their contractual obligations, so any additional revenue must relate to the achievement of capacity above the contractual position.

Vale does not support the current proposal by ARTC to exclude all of the Ad Hoc Charges from the revenue Ceiling as the TOP component of this charge includes an allowance for the return on ARTC's investment in the infrastructure. The rate of return provided to ARTC is part of the revenue Ceiling received by ARTC for their investment in the infrastructure and Vale believes the exclusion of this revenue from the Ceiling calculation would result in an inefficient cost to Access Holders. Vale supports the concept outlined in section 6 of the Paper that provides ARTC with the option to retain the Non-TOP component of the Ad Hoc Charge and 50%-75% of the TOP component. Vale believes this approach is necessary otherwise Access Holders would pay for the return on capital under the revenue Ceiling and then again for using the Ad Hoc Train Path. Vale believes an adjustment to the TOP Charge is important to maintain an efficient pricing approach to encourage appropriate network investment decisions.

3. **If ARTC is permitted to retain revenue outside of the Ceiling, do you foresee any related issues that would need to be addressed, and how might these be mitigated?**

Providing an opportunity for a financial incentive for an entity subject to a revenue cap does present some challenges, as ARTC's revenue risk is very low. The challenge under this situation is to develop an incentive scheme that reflects this low risk and avoids the incentive scheme becoming a means to increase ARTC's return with very little risk and limited positive action. Vale believes that it is important to establish a robust baseline for the determination of the incentive so that any financial reward provides for outperformance of ARTC's contractual position. Vale believes the baseline must include the achievement of all contractual positions of Access Holders and the efficient infrastructure required to meet this contractual position. The proposed incentive is likely to encourage ARTC to over invest in infrastructure to increase Ad Hoc train path opportunities on the network so it will be important to ensure there are provisions within the HVAU that require infrastructure to only be constructed to match capacity and requiring ARTC to contract that capacity.

The governance of the incentive scheme will also be important to ensure it provides clear and transparent information to all stakeholders. The undertaking is a voluntary document and outside the reset periods, is generally only available for ARTC to request amendments. Vale believes this result allocates the revenue risk of any incentive scheme to Access Holders, as the higher returns will not incentivise ARTC to amend the incentive scheme. Vale believes that all stakeholders should be provided with sufficient information on the operation of the incentive scheme to provide transparency on its effectiveness in achieving the stated outcomes. One way of achieving this is setting a clear and transparent goal of the incentive scheme, and establishing an audit and review processes.

As previously stated, Vale does not support the proposed approach that allows the exclusion of the full Ad Hoc Charge from the revenue Ceiling. Vale does not believe this approach supports efficient pricing and supports the approach that only allows the exclusion of 50%-75% of the TOP component of the Ad Hoc Charge, from the revenue Ceiling.

Vale also seeks further clarity on the concept to capture the Ad Hoc Charge revenue for each Pricing Zone. An Ad Hoc train path provided in either Pricing Zone 2 or 3, ultimately results in the use of an Ad Hoc train path in Pricing Zone 1. Vale believes it is important to understand the interaction of this concept with the requirement to achieve the contractual capacity of each Access Holder and how the revenue is allocated between the various Pricing Zones over which the train operates. Vale is seeking further information from ARTC before it could provide an informed view, and believes the use of examples would assist in this understanding.

4. **Do you foresee any negative impact on other mechanisms under the HVAU, e.g. trading? How might these negative impacts be mitigated?**

Vale is concerned that ARTC believes one of the key risks to implementing this incentive proposal is that ARTC will not continue to actively assist and encourage Access Holders to complete capacity transfers. Vale believes that one of the fundamental principles identified during the long-term solution was an active and efficient transfer mechanism to encourage the efficient use of the regulated infrastructure. Vale believes that a transfer mechanism is fundamental in the efficient use of infrastructure and any mechanism that may limit this function is not likely to lead to an efficient outcome. The need to transfer capacity is likely to take on a greater focus in the coal chain as system capacity approaches the ARTC contractual capacity as Access Holders seek to manage their capacity holdings to align with fluctuating production profiles. Vale is also concerned that a passive approach to transfers could lead an Access Holder to request further infrastructure expansions to service their needs rather than the possible uncertainty of Ad Hoc train paths, if there is no active encouragement to transfer capacity.

5. **Do you support the adoption of the proposed incentive mechanism? Please provide reasons for your view.**

Vale has reviewed ARTC's Paper and does not believe the proposed incentive mechanism will encourage ARTC to operate the rail network in a more efficient manner. Vale's evaluation of the incentive proposal indicates that ARTC is not required to achieve the network contractual capacity compensated for under the revenue Ceiling. Vale outlines its understanding of the proposal in the example below.

The hypothetical example assumes there are two Access Holders that require access to transport coal on the rail network. Producer A and Producer B have both contracted 10 Annual Contracted Path Usages (ACP) with ARTC. During the year, Producer A operates 12 Actual Path Usages (APU) and Producer B operates 8 APUs. Assuming ARTC meets its TUT requirements for the year and no capacity transfers are completed, producer A would pay ARTC the cost of operating the 12 APUs which included Ad Hoc Charges for 2 APUs and would not be entitled to a rebate as it utilised its ACPs for the year. Producer B would pay ARTC for 8 APU's as well as the take or pay charge for the 2 ACPs that it did not utilise. Vale's reading of the Paper seems to suggest that ARTC's proposed incentive would allow them to retain the Ad Hoc Charges for the 2 paths operated by Producer A above its ACP even though this capacity was effectively provided by Producer B not utilising its full ACP, as opposed to ARTC creating additional paths through operational efficiencies. Therefore, Producer B has paid ARTC the ToP Charges on the 2 train paths not utilised which would be included in the revenue Ceiling assessment, and ARTC would be allowed to retain the Ad Hoc Charges paid by Producer A for utilising more than its ACP, as this would be excluded from the revenue Ceiling assessment.

Vale does not support the proposed incentive scheme, as it believes that it;

- Does not have sufficient clarity on the details of the incentive scheme to make an informed view. Vale does not believe that it contains a clear process to establish the incentive baseline.
- Does not improve efficiency of the network as the proposal suggests that ARTC's total contractual obligation are not required to be achieved for it to be provided with a financial benefit. The proposal suggests that ARTC needs to achieve above an individual Access Holders contractual position to gain a financial incentive. Vale's believes this could lead to discriminatory behaviour by ARTC as it prioritises one individual Access Holder over another if it could achieve a financial incentive.
- Does not encourage the efficient utilisation of the network via the trading mechanism, as there is a financial incentive for ARTC not to actively pursue capacity trading. Vale believes this could result in inefficient decisions to construct infrastructure.
- Vale does not believe it is efficient to provide ARTC with the full value of the Ad Hoc Charge as this includes a return for the investment on the infrastructure. Vale believes ARTC is already provided with a rate of return within the revenue cap Ceiling.
- Vale seeks further clarity via examples of how the revenue would be allocated to pools across Pricing Zones given that an Ad Hoc Train Path provided within either Pricing Zone 2 or 3 will reduce the availability of train paths in Pricing Zone 1.
- If a proposal were included in the HVAU, Vale would like to see more consultation on expected reporting timeframes. Vale believes it would be valuable for stakeholders to have regular reporting on the incentive to provide a clear understanding of the cost implications that any incentive scheme will pose to their business during the year to allow for an appropriate response.
- Vale would also like to the incentive scheme to include a future audit and review process to allow stakeholders to assess the benefits of the incentive to their business and the coal chain as a whole. Critical to this review will be the determination of whether the incentive mechanism is driving efficient behaviour of ARTC to increase the coal chain throughput

Vale notes that ARTC's development path includes the review of submissions as part of this consultation process and then a submission to the ACCC detailing the feedback and if applicable a submission for an amendment to the HVAU to incorporate an incentive scheme. Vale would encourage ARTC to provide at least some initial feedback to stakeholders on the general issues raised during the ARTC consultation process and ARTC's views and assessment of these matters prior to any submission to the ACCC. Vale would encourage ARTC to conduct further discussions with stakeholders and provide an outline of the expected approach it will take with the submission to the ACCC as this additional feedback prior to the submission to the ACCC that could aid the efficiency of the process.

For further information regarding this advice, please contract myself on (07) 3136 0936.

Yours sincerely

Paul Hartfiel

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